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REMARKS

Info copy of EPC Meeting papers for 30 July meeting attached. I was not able to attend this session.

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THE WHITE HOUSE

WASHINGTON

July 26, 1985

MEMORANDUM FOR THE ECONOMIC POLICY COUNCIL

FROM: ROGER B. PORTER RBP

SUBJECT: Agenda and Papers for the July 30 Meeting

The agenda and papers for the July 30 meeting of the Economic Policy Council are attached. The meeting is scheduled for 2:00 p.m. in Room 248 of the Old Executive Office Building.

The first agenda item concerns the U.S.-E.C. steel negotiations. Ambassador Yeutter and the Office of the U.S. Trade Representative have been negotiating with the European Commission regarding imports of steel "consultation products." A paper prepared by USTR is attached.

The second agenda item concerns the Japanese Government Action Plan for Imports. The Japanese Government is expected to make its action plan available to U.S. officials on Monday, July 29. By Tuesday afternoon we will have had an opportunity to make a preliminary evaluation of the Action Plan and to discuss when and how the Administration should respond. No paper will be circulated for this agenda item in advance of the meeting.

The third agenda item concerns agricultural credit policy and specifically the Farm Credit System. The Working Group on Agricultural Credit Policy has prepared a paper on "The Farm Credit System" focusing on the question of whether the Federal government should assist the Farm Credit System and, if so, in what form should that assistance be provided. A copy of this paper is attached.

Attachments

THE WHITE HOUSE

WASHINGTON

ECONOMIC POLICY COUNCIL

July 30, 1985

2:00 p.m.

248 OEOB

AGENDA

1. U.S.-E.C. Steel Negotiations
2. Japanese Action Plan for Imports
3. Agricultural Credit Policy: Farm Credit System

Issue

How should the Administration address the substantial increase in imports of "consultation products" from the EC?

Background

The 1982 US-EC Steel Arrangement did not specifically restrain the so-called "consultation products." EC exports of these products were relatively insignificant through 1981. These products include semi-finished steel, wire and wire products, cold finished bar, etc. The Arrangement, however, provides a mechanism to prevent diversion from products licensed under the Arrangement into these consultation products. The Arrangement further provides that if imports of these products show a significant increase indicating the possibility of diversion from the licensed products, consultations will be held "with the objective of preventing such diversion, taking into account the 1981 market share levels." If the consultations demonstrate that there has been diversion which impairs the Arrangement's objectives, then "both sides will take the necessary measures for the products concerned in order to prevent such a diversion."

In 1981, imports of these consultation products from the EC accounted for 2.6 per cent of U.S. consumption. In 1984, this level was 8.7 per cent and during the first four months of 1985, imports of these products took 9.3 per cent of the U.S. market -- more than three and a half times the 1981 level.

After months of informal consultations with EC Commision officials on this matter, we requested formal consultations on February 8, 1985. The Arrangement provides that should these consultations demonstrate that such diversion has occurred, necessary measures to prevent such diversion will be taken within 60 days. The 60 day formal period ended on April 9 without any agreement.

Recent Negotiating Efforts

On June 1, the U.S. agreed to allow entry of 100,000 tons of line pipe for the All American Pipeline without this tonnage counting against the US-EC Steel Arrangement. The EC, among other things, committed to immediately enter into negotiations to restrain exports of the consultation products. The Europeans (and the U.S. industry) understood that if an acceptable resolution of this issue were not reached by August 1, the U.S. would act unilaterally to restrain EC exports of these consultation products.

EC Offer

The EC failed to make any offer until July 19 -- four days after the deadline that it had suggested for reaching agreement. That proposal would have resulted in an increase in imports from the EC above the 1984 surge. Since then, they've reduced their offer marginally to just 10 per

cent below 1984 (to 538,000 tons).

U.S. Offer

Finished Steel - In the last of a series of offers, the U.S. has suggested EC restraint of 475,000 tons (on an annual basis) for the second half of 1985, a level well above the 332,000 tons of these products exported in 1981 and 25 per cent below the EC's 1984 level of 634,000 tons. A reduction of this amount is less than that attained to date in the 14 steel arrangements negotiated under the President's steel program. Further, as a major concession, the U.S. offered to initiate this restraint on July 1, forgiving the EC's excessive surges in the first half of 1985.

Semi-finished Steel - In an effort to facilitate a settlement, the U.S. side offered to set aside the sensitive issue of semi-finished steel (which accounts for 56% of EC consultation product exports in 1984) for discussion later in the fall when the existing Arrangement is due to be renegotiated.

The success of the President's steel program, and our future steel negotiations this fall, will be impacted heavily by our handling of this problem. Fourteen other countries -- including many with far better records as fair traders -- have agreed to reduce their exports for 5 years, retroactive to October 1 of last year.

The U.S. should keep an open line of communication with the EC right up to the August 1 deadline. If no agreement can be attained, however, unilateral U.S. action is essential if we are to maintain the credibility of the President's program.

THE WHITE HOUSE

WASHINGTON

July 26, 1985

MEMORANDUM FOR THE ECONOMIC POLICY COUNCIL

FROM: THE WORKING GROUP ON AGRICULTURAL CREDIT POLICY

SUBJECT: The Farm Credit System

Issue: Should the Federal Government assist the Farm Credit System and, if so, in what form should that assistance be provided?

The Council earlier reviewed the issue of agricultural credit policy, in general, and the problems of the Farmers Home Administration (FmHA), in particular. A second major component of the agricultural credit problem is the financial difficulties faced by the Farm Credit System (FCS). Regardless of how the Federal Government addresses the problems of the FmHA, the Farm Credit System will still represent a potentially destabilizing force in the agricultural sector.

This memorandum reviews the problems of the FCS, the policy objectives that should guide consideration of any Federal assistance to the FCS, and the range of viable options.

Farm Credit System

The FCS is a government-sponsored enterprise designed to provide inexpensive credit to the agricultural sector. The FCS is able to borrow at about 5-20 basis points above Treasury securities because the market believes the Federal Government will back its securities even though there is no explicit guarantee (although reports suggest this spread has widened in light of recent press reports about the FCS's financial difficulties). Moreover, the Farm Credit Administration (FCA), which supervises the FCS, has a line of credit of about $250 million with the U.S. Treasury. The FCS holds the largest share of farm debt, about $68 billion, or 32 percent, of the $213 billion outstanding at the end of 1984.

The FCS divides the country into 12 farm credit districts, each of which is served by one Federal Land Bank (FLB) making long-term real estate loans, one Federal Intermediate Credit Bank (FICB) making short- or intermediate-term loans, and one Bank for Cooperatives (BC) making loans of all kinds. In addition, there is a Central Bank for Cooperatives in Denver. There are, therefore, 37 Farm Credit Banks. A chart outlining the structure of the FCS is attached.

The overall condition of the FCS is basically sound. Of the $13 billion in stock, retained earnings, and loss allowances, the FCS has $4 billion to $6 billion in relatively liquid assets and also holds about $500 million to $1 billion of unused short-term lines of credit.

Notwithstanding the overall sound condition of the FCS, several elements of the system, particularly the short-term lending operations in the FICBs, are facing severe financial difficulties. An analysis by the FCA indicates that a total of about $1.8 billion may be required within 60-90 days to stabilize several problem FICB districts, particularly the Omaha district (including Nebraska, South Dakota, Iowa, and Wyoming). The FCA is planning to analyze the condition of the Federal Land Banks given the likely impact of substantial declines in land values on their financial condition.

FCS lenders with substantial nonperforming assets are attempting to generate income by raising their interest rates above market rates. Given the general decline in interest rates, many good credit borrowers are moving to other lenders, which forces FCS lenders to raise rates even higher for the remaining borrowers. Thus, the FCS needs to address its problems quickly.

The fundamental problems faced by the FCS are twofold. First, the system is highly decentralized and operates on a consensus management basis. Because the FCS's equity is spread among about 900 separate entities and these entities are required to share losses only if there is a technical default, districts requiring additional equity in order to stabilize operations cannot easily draw on the reserves of other districts. Second, the FCA lacks regulatory authority and the necessary enforcement powers to require acceptable credit standards.

The FCA believes that it will succeed in solving its problems without any Federal aid or interference. FCS members are concerned that any Federal assistance will be tied to significant reform of the system that will make it harder for them to obtain credit. The FCA may be overly optimistic about overcoming the problems posed by a decentralized structure. In addition, because the FCA has completed an analysis of only the Production Credit Associations (to which the Federal Intermediate Credit Banks lend) and not the Federal Land Banks or Banks for Cooperatives, it may be underestimating the seriousness of the problem. Given this uncertainty, it is unclear whether its approximately $4.5 billion to $7 billion in liquid assets and unused lines of credit are sufficient.

The first test of whether the FCS can resolve its short-term lending problems will be its implementation of a "financial rescue package" for the Omaha FICB. The FCA has proposed that other elements of the FCS provide $435 million to bail out the Omaha FICB. The local farm credit bank boards must approve this proposal, which the FCA hopes to implement starting September 1.

Policy Objectives

The Administration has several key objectives that should guide its decision on whether to assist the Farm Credit System:

- It should establish a framework in which the flow of credit into the agricultural sector eventually conforms more closely with the market allocation of credit. Greater credit availability for the agricultural sector would exacerbate the fundamental problem of excess productive capacity in the sector.

- It should minimize the short- and long-term budget costs. It needs to assess whether the budget costs of assisting the FCS now would be more or less than assistance later, if necessary.

- It should seek to achieve regulatory reform of the Farm Credit System in order to reduce the likelihood of future difficulties. The FCA needs to have appropriate regulatory authority and enforcement powers to supervise FCS operations comparable to that provided the commercial banking industry by the Federal Deposit Insurance Corporation (FDIC) and the Comptroller of the Currency. It should be responsible for auditing the FCS and providing strict regulatory standards. Where necessary, it should have power comparable to the FDIC to liquidate or merge unhealthy FCS institutions.

Policy Options

Option 1: Encourage the FCS to solve its problems without Federal aid or interference.

Under this proposal, the Administration would work with the Congress to encourage the FCS to mobilize its internal resources to improve its financial position. The FCS will need to implement adequate loss-sharing agreements, mobilize its equity and reserves, and place its accounting and loan arrangements on a sounder financial basis. The possibility of higher interest rates on its securities and the absence of Federal assistance could maximize the pressure on the FCS to reform.

Advantages

- Having the FCS put itself back on a sound financial basis through loan liquidation and more stringent standards for new loans would help make the flow of agricultural credit more consistent with a market allocation of credit.

- This proposal would avoid any immediate direct Federal budget costs.

- This proposal would strengthen the Administration's position in opposing the bailing out of government-sponsored enterprises generally.

Disadvantages

- If the FCS were to default on its obligations and were unable to provide credit, the farm sector would face substantial contraction as available credit diminished.

- Not providing Federal assistance now may result in greater costs of assistance later if it appears the system were going to default in the future.

- If the FCS were to default on its obligations and were unable to provide credit, the FmHA could face a substantial increase in demand for loans.

Option 2: Require the FCS to utilize its internal resources, restructure the FCA to provide it strong regulatory authority, enforcement powers, and Federal oversight, and reform the FmHA: (a) limit FmHA direct lending to servicing its existing portfolio; (b) eliminate FmHA real estate lending; and (c) authorize FmHA to guarantee new operating loans up to a maximum of 70 percent under existing qualification rules.

The Federal Government would provide a line of credit over and above the current $250 million or direct Federal financing for FCS from the Treasury.

Under this proposal, in exchange for requiring the FCS to utilize its internal resources, providing the FCA with strong regulatory authority, and reforming the FmHA, the Administration would support providing Federal Government financing for FCS. The Treasury would match funds from the FCS by providing a larger line of credit or a direct capital infusion in order to allow the FCS to maintain financial operations while it removed nonperforming loans from its weak units. If Federal funds are drawn upon, the FCA would function much like a court-appointed receiver. This proposal also assumes that in order to reduce the likelihood of this problem recurring, the FCA would, after the initial stabilization of the existing system, provide some form of insured funding through premiums based on outstanding loans of the FCS.

Advantages

- Providing Federal Government financing for the FCS could help achieve the needed reorientation of FmHA.

- It would permit the FCS and other private institutional lenders to remain a viable and competitive source of credit to individual operators while a new farm policy is implemented over the next three to four years.

- For the first time, there would be strong accountability for individual institutions within the FCS.

Disadvantages

- The direct Federal budget exposure could be substantial with a significant risk that part or all of the direct Federal outlays would not be repaid.

- Providing Federal Government financing for the FCS would delay the necessary restructuring of the farm sector.

- Commercial banks, insurance companies, and other lenders may object that the Federal Government is aiding only one component of the agricultural lending sector, and pressure the Government for access to similar resources.

Option 3: Require the FCS to utilize its internal resources, restructure the FCA to provide it strong regulatory authority, enforcement powers, and Federal oversight, and reform the FmHA: (a) limit FmHA direct lending to servicing its existing portfolio; (b) eliminate FmHA real estate lending; and (c) authorize FmHA to guarantee new operating loans up to a maximum of 70 percent under existing qualification rules.

The Federal Government would create a Federally-chartered, partially Federally-guaranteed, and privately-owned credit institution (Aggie Mae) to purchase nonperforming farm real estate and equipment loans from any recognized financial institution.

Under this proposal, in exchange for requiring the FCS to utilize its internal resources, providing the FCA with strong regulatory authority, and reforming the FmHA, the Administration would support creating an Aggie Mae. Financial institutions holding nonperforming real estate or equipment loans would obtain voluntary or forced liquidations and sell the collateral on a discounted basis to Aggie Mae, which would manage the real estate or equipment for five to ten years. Aggie Mae would lease the real estate or equipment to any qualified operator and use those proceeds to service its debt. The FCS may resist restructuring because all agricultural lenders would reap the benefits of an Aggie Mae while only the FCS is required to undertake reforms.

Advantages

- Creating an Aggie Mae could help achieve the needed reorientation of FmHA.

- It would permit the FCS and other private institutional lenders to remain a viable and competitive source of credit to individual operators while a new farm policy is implemented over the next three to four years.

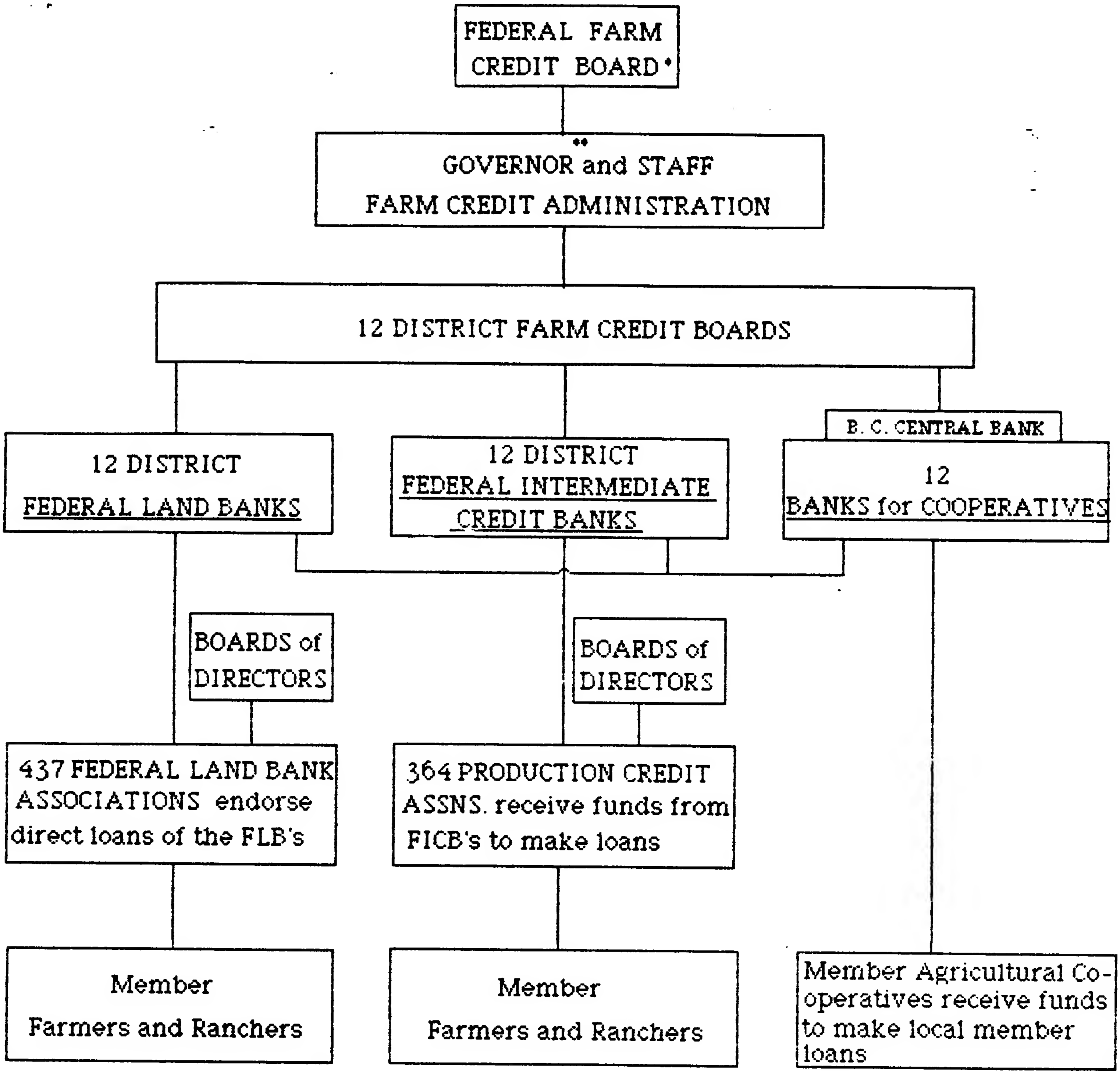
- This proposal would avoid immediate direct Federal budget outlays and require State governments and private lenders to share the risk (through partial loan guarantees).

Disadvantages

- Creating an Aggie Mae could inhibit the necessary restructuring of the agricultural sector by providing a new source of subsidized credit to the sector.

- Creating an Aggie Mae with partial Federal guarantees of problem loans places the Federal Government at an unknown, but potentially large, risk.

- Creating an Aggie Mae would create a precedent for other troubled lenders such as thrift institutions to seek a similar dumping ground for problem loans.



* The Federal Farm Credit Board has 13 members. The President appoints 12 members, one from each district, and the Secretary of Agriculture appoints 1 member.

** The Governor is appointed by the Board